No. 11,829

PETITIONER'S OPENING BRIEF

United States Circuit Court of Appeals

For the Ninth Circuit

Mitchell Camera Corporation,

Petitioner

v.

Commissioner of Internal Revenue,

Respondent

Upon Petition to Review a Decision of the Tax Court of the United States

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JURISDICTIONAL STATEMENT

Mitchell Camera Corporation, petitioner, seeks the redetermination of a deficiency in federal income taxes determined by respondent to be payable for the taxable year ended December 31, 1941. It filed its returns for the years involved with the Collector for the Sixth District of California. Jurisdiction of the proceedings was conferred upon the Tax Court of the United States by section 1100 et seq. of the Internal Revenue Code (26 U. S. C. A.

section 110, et seq.). The provisions of section 1141 of the Internal Revenue Code (26 U. S. C. A. section 1141) give jurisdiction to this Court. The pleadings necessary to show the existence of jurisdiction are the Amended Petition for redetermination of deficiency (R. 5) and the answer thereto (R. 20). From the decision of the Tax Court (R. 68) determining a deficiency in income tax of $47,720.78 for the year 1941, petitioner has filed its Petition for Review by this Court (R. 71).

STATEMENT OF THE CASE AND QUESTIONS INVOLVED

The principal issues in this case concern the basis to petitioner of a group of patents which it purchased in 1929 and the correct formula for depreciating such basis over the life of the patents. The facts are set out in detail in the opinion of the Tax Court (R. 26) but may be summarized as follows:

The Mitchell Camera Company of California (hereinafter referred to as Mitchell of California) (not the petitioner) for a number of years prior to 1929 was engaged in the business of manufacturing professional motion picture cameras and accessories for the large motion picture studios in California. All of its business was in patented products manufactured under patents which it owned. In 1929 the introduction of "sound" motion picture revolutionized the motion picture industry and Mitchell of California became the sole supplier of cameras for the major motion picture studios. This was because it produced a relatively noiseless camera as compared with that of competitors. Because of the patented features of the Mitchell camera it was practically impossible to use any other camera in the production of "sound" motion pictures (R. 28).

In the early part of 1929, Harley L. Clarke became interested in acquiring the business and assets of Mitchell of California (R. 28, 29). He communicated with William Fox, who also agreed to take an interest in this acquisition (R. 30, 31). On June 6, 1929, Clarke contracted to purchase all the assets of Mitchell of California for $1,475,000.00.

In 1929, Clarke owned "just over control" in General Theatres Equipment, Inc. It received $11,400,000 from the sale of its securities (R. 45). Of this fund $2,000,00 was used to acquire half of the capital stock of Grandeur, Inc. (R. 45, 34). (An additional $3,000,000 was paid to Clarke to acquire four lamp companies in a transaction not directly here involved) (R. 48). William Fox acquired the other half of Grandeur's stock for $2,000,000 (R. 34, 45). Clarke was president of Grandeur and of General Theatres Equipment Inc. (R. 56).

Petitioner was incorporated in the State of Delaware on July 12, 1929 (R. 38). Clarke became its president (R. 56). Its charter provided that a director's transactions with the corporation should not be voidable in the absence of fraud or non-disclosure, and that he need not account for the profit on any such transaction (R. 38, 39).

On July 12, 1929, Clarke proposed to sell to petitioner for $3,100,000.00 in cash all of the assets of Mitchell of California (R. 40; Ex. 1). Petitioner accepted this offer at a meeting of its board of directors on July 16, 1929 (R. 41; Ex. 2). At the same meeting, Clarke presented to petitioner a proposal by Grandeur, Inc., to purchase all of petitioner's capital stock for $3,100,000 (R. 41), and petitioner accepted this proposal (R. 42).

The above agreements were duly carried out. Clarke caused Mitchell of California and its stockholders to transfer to petitioner, or to an escrow agent, the assets which

Clarke had previously contracted to purchase (R. 22, 42, 44). Clarke paid Mitchell of California's stockholders $1,475,000 for the assets in accordance with his agreement (R. 44). He testified that he also paid between $350,000 and $400,000 in commissions on the purchase (R. 117, 118, 122). Grandeur deposited to petitioner's account its check in payment for petitioner's stock (R. 46). Petitioner issued its check to Clarke for $3,000,000 ($100,000 having been previously paid) for the Mitchell of California assets in accordance with its agreement (R. 47).

In settlement of an income tax controversy for the years 1930 and 1931 respondent, in a computation dated January 5, 1934, fixed, as petitioner's basis for the Mitchell of California assets, the price which Clarke had paid for those assets, and computed depreciation accordingly (R. 50, 51). Petitioner executed a waiver, Treasury Form 870, agreeing to revised deficiencies on this basis for those years (R. 51, 52).

For the taxable years 1939, 1940 and 1941, respondent proposed to revise the patent depreciation which petitioner had reported on its returns (R. 54). His theory, as in his 1934 computation, was to fix petitioner's cost of the patents at what he determined to be Clarke's cost, and to depreciate or spread this cost over the average life (12.3666 years) of the group of patents from the date of their acquisition (R. 23, 24, 54, 55). The petitioner seeks to have the cost spread over the full life of the patents. This, together with minor issues not involved in this appeal, resulted in a notice of deficiency in income and declared value excess profits taxes for 1941 in the amounts of $71,301.66 and $2,177.28 respectively (R. 26). The years 1939 and 1940 are also involved because of carry over net losses for those years (R. 26).

Petitioner duly filed its petition with the Tax Court of the United States, and, after hearing, the Tax Court

entered its findings of fact and opinion sustaining the respondent on the depreciation issues (R. 26, 57). Petitioner then filed, but the Tax Court denied, a motion requesting the Tax Court to vacate its findings of fact and opinion on the ground that it had failed to observe the procedures prescribed by the Administrative Procedure Act (60 Stat. 237, 5 U. S. C. §1001) (R. 69).

Following the entry of the above opinion, respondent filed a computation, in which petitioner acquiesced subject to right of appeal, reducing the asserted income tax deficiency of petitioner for the year 1941 to $47,720.78 and eliminating the deficiency in declared value excess profits tax. The Tax Court on September 9, 1947, entered its final decision determining a deficiency in accordance with this computation (R. 68). From this decision, petitioner filed its petition for review by this Court (R. 71).

The questions involved on this review are: (1) Method for determining the basis for depreciation of patents which petitioner acquired when it purchased from Harley L. Clarke all the assets of Mitchell of California; (2) whether the Tax Court could properly exclude from Clarke's cost of the assets commissions which he testified he paid to acquire them; (3) whether the depreciation on a group of patents having varying lives should be spread over the average life, or over the full life of all the patents under a proper formula; (4) whether the basis of patents for the years involved may be adjusted to reflect the correct cumulative depreciation for prior years to the extent that excessive depreciation charges erroneously taken did not result in tax benefit; (5) whether the Tax Court is an agency subject to the Administrative Procedure Act, and if so, what effect this has on its procedures and the scope of review of its decisions.

SPECIFICATION OF ERRORS RELIED ON

1. The Tax Court erred in not holding and deciding that the correct basis for depreciation of the patents which petitioner acquired when it purchased the assets of Mitchell of California was $3,100,000.00, less the agreed value of the tangible assets.

2. The Tax Court erred in holding and deciding that the basis for depreciation of patents which petitioner purchased from Harley L. Clarke is to be determined by reference to the price which Clarke paid to Mitchell of California for its assets.

3. The Tax Court erred in holding and deciding that the assets of Mitchell of California acquired by petitioner included substantial value in goodwill and intangibles other than patents, and that any part of the purchase price was paid for such goodwill and intangibles.

4. The Tax Court erred in holding and deciding that a figure other than the stipulated value of the net tangible assets might be deducted from the total cost of the assets formerly owned by Mitchell of California in arriving at the cost basis to petitioner of the patents included in such assets.

5. The Tax Court erred in not holding and deciding that the $350,000.00 to $400,000.00 which the Government witness, Harley L. Clarke, testified without contradiction that he paid as commissions to acquire the assets of Mitchell of California must be added to Clarke's cost of the assets if such cost is to be treated as the cost of assets to petitioner.

6. The Tax Court erred in holding and deciding that the Commissioner might properly compute depreciation on the group of patents acquired by petitioner on the basis of the average life of the patents, rather than by

spreading depreciation over the entire life of all the patents.

7. The Tax Court erred in not holding and deciding that, where petitioner through error took depreciation for the years 1932 through 1938 in excess of the correct amount, but except for the year 1936 received no tax benefit as a result, the basis for computing depreciation for the years in controversy should be adjusted to reflect the correct amount of depreciation for earlier years.

8. The Tax Court erred in entering its final order and decision that there is a deficiency in petitioner's income tax for the year 1941 of $47,720.78.

9. The Tax Court erred in denying petitioner's motion to set aside its memorandum findings of fact and opinion for the reason that the Tax Court is an agency of the United States within the meaning of the Administrative Procedure Act (Chapter 324, 60 Stat. 237, 5 U. S. C. §1001), and petitioner was given no opportunity as required by that Act to submit objections or to file exceptions to said opinion or "initial decision" prior to its issuance, or to obtain review by the Tax Court of the report of the Judge who heard the case.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code (1939).

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

"* * * *

"(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *"

"(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114."

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

"(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property."

"SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

"(a) *Basis (unadjusted) of property.*—The basis of property shall be the cost of such property; except that—* * *

"(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided."

"(1) *General Rule.*—Proper adjustment in respect of the property shall in all cases be made—* * *

"(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws. * * *."

"SEC. 1100. STATUS.

"The Board of Tax Appeals (hereinafter referred to as the 'Board') shall be continued as an independent agency in the Executive Branch of the Government. The Board shall be known as the Tax Court of the United States and the members thereof shall be known as the presiding judge and the judges of The Tax Court of the United States."

"SEC. 1116. HEARINGS.

"Notice and opportunity to be heard upon any proceeding instituted before the Board shall be given

to the taxpayer and the Commissioner. * * * Hearings before the Board and its divisions shall be open to the public, and the testimony, and, if the Board so requires, the argument shall be stenographically reported. * * *''

Administrative Procedure Act, 60 Stat. 237, 5 U. S. C. §1001).

''Sec. 2. As used in this Act—

''(a) Agency.—Agency means each authority (whether or not within or subject to review by another agency) of the Government of the United States other than Congress, the courts, or the governments of the possessions, Territories, or the District of Columbia. * * *''

''Sec. 5. In every case of adjudication required by statute to be determined on the record after opportunity for agency hearing * * *

''(b) Procedure.—The agency shall afford all interested parties opportunity for * * * hearing, and decision upon notice and in conformity with sections 7 and 8.''

''Sec 7. In hearings which section * * * 5 requires to be conducted pursuant to this section—

''(a) Presiding Officers.—There shall preside at the taking of evidence (1) the agency, (2) one or more members of the body which comprises the agency, or (3) one or more examiners appointed as provided in this Act; * * *.''

''Sec 8. In cases in which a hearing is required to be conducted in conformity with section 7—

''(a) Action by Subordinates.—In cases in which the agency has not presided at the reception of the evidence, the officer who presided * * * shall initially decide the case or the agency shall require * * * the entire record to be certified to it for initial decision. Whenever such officers make the initial decision and in the absence of either an appeal to the agency or review upon motion of the agency within time provided by rule, such decision shall without further

proceedings then become the decision of the agency. * * * Whenever the agency makes the initial decision without having presided at the reception of the evidence, such officers shall first recommend a decision * * *."

"(b) SUBMITTALS AND DECISIONS.—Prior to each recommended, initial, or tentative decision, or decision upon agency review of the decision of subordinate officers the parties shall be afforded a reasonable opportunity to submit for the consideration of the officers participating in such decisions (1) proposed findings and conclusions, or (2) exceptions to the decisions or recommended decisions of subordinate officers or to tentative agency decisions, and (3) supporting reasons for such exceptions or proposed findings or conclusions. The record shall show the ruling upon each such finding, conclusion, or exception presented. All decisions (including initial, recommended, or tentative decisions) shall become a part of the record and include a statement of (1) findings and conclusions, as well as the reasons or basis therefor, upon all the material issues of fact, law, or discretion presented on the record; and (2) the appropriate rule, order, sanction, relief, or denial thereof."

"SEC. 10. Except so far as (1) statutes preclude judicial review or (2) agency action is by law committed to agency discretion—

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(e) SCOPE OF REVIEW.—So far as necessary to decision and where presented the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of any agency action. It shall * * * (B) hold unlawful and set aside agency action, findings, and conclusions found to be (1) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law; * * * (4) without observance of procedure required by law; (5) unsupported by substantial evidence in any case subject to the requirements of sections 7 and 8 or otherwise reviewed on the record of an agency hearing provided

by statute; * * * In making the foregoing determinations the court shall review the whole record or such portions thereof as may be cited by any party * * *."

Commissioner's Regulations 103.
"Sec. 19.23 (1)-1. *Depreciation.* * * *

"The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will at the end of the useful life of the property in the business, equal the cost or other basis of the property determined in accordance with section 113. * * *."

"Sec. 19.23 (1)-7. *Depreciation of patent or copyright.*—"* * * The allowance should be computed by an apportionment of the cost or other basis of the patent or copyright over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer, or in the case of a copyright, since March 1, 1913, as the case may be. * * *."

SUMMARY OF ARGUMENT

1. The petitioner's basis for its patents acquired in 1929 is its cost. All of the evidence shows that petitioner's cost of the assets of Mitchell of California was $3,100,000, the price which it paid Harley L. Clarke for those assets. It is irrelevant to a determination of petitioner's cost, and therefore basis, that Clarke paid a lesser sum for the assets in a prior transaction; nor may Clarke's profit be excluded in determining petitioner's cost simply because Clarke was an officer of, and had an interest in, petitioner.

2. Petitioner's cost or basis for the patents was $2,860,178.95, the difference between its cost of all the assets and the stipulated value of the tangible assets. No part of the price which petitioner paid to Clarke for the assets is attributable to good will because all of Mitchell of Cali-

fornia's value, apart from tangibles, was in patents. As the Tax Court found, Mitchell's monopoly position in the camera industry and its large backlog of orders in 1929 were due to the patented features of the Mitchell camera (R. 28). Moreover, the parties testified without contradiction that the entire consideration for the assets, above the cost of the tangibles, was paid for patents—not for good will or anything else.

3. The Tax Court erred in sustaining a deduction of $294,842.41 from total cost in arriving at the cost of the patents, when a value of $239,821.05 for the tangible assets was stipulated. The difference of $55,021.36 is not, as the Tax Court says, attributable to intangibles other than good will for no such intangibles existed. Instead this difference has its origin in an error which respondent's agent made in a 1934 computation (R. 51) in the exact amount of $55,021.36.

4. If petitioner's basis is to be measured by Clarke's cost, $350,000 which Clarke paid in commissions to acquire the Mitchell assets must be included as part of his cost of those assets. The evidence that Clarke paid these commissions to secure the Mitchell assets was clear, uncontroverted, and came from respondent's own witness. The Tax Court erred in holding that more evidence was required to sustain the commission payment, but even if this were true it should have afforded the parties an opportunity to adduce such evidence.

5. Patents must be depreciated over their full life. The respondent's regulations, implementing the statute, so provide. Where a group of patents are acquired, having varying lives, this requirement is met by applying the formula used in *Simmons Company v. Commissioner*, 8 BTA 631, 644, aff'd 33 F. 2d 75. Under this formula the allowable depreciation in each year is an amount which bears the same ratio to the total value of all the patents as the patent life expiring in that year bears to the total

unexpired life on the acquisition date. This is the only formula which spreads depreciation over the full life of all the patents and thus conforms to the respondent's regulations. Respondent's insistence that patent depreciation be taken instead on an "average life" basis would result in exhaustion of the basis for depreciation while seventeen of the thirty patents were still alive; the average life formula, as applied to these patents, is therefore contrary to respondent's own regulations. Since the formula which petitioner desires to use is admittedly proper, it should not be required to use some other formula which the respondent proposes.

6. The amount of depreciation by which patent basis was reduced to December 31, 1938 should be adjusted to reflect the correct cost basis and the correct method of spreading depreciation. This will not result in undeserved advantage to petitioner since it secured no tax benefit from the excessive depreciation charges. *Virginian Hotel Corporation v. Helvering*, 319 U. S. 523, does not preclude adjustment of depreciation on intangibles. Furthermore the present case involves merely correction of mathematical errors, where no tax benefit resulted therefrom.

7. The Tax Court is subject to the Administrative Procedure Act. It is not a court but is by law "an independent agency in the executive branch of the Government." The legislative history of the Act shows that Congress intended it to apply to *all* agencies, including the Tax Court. The Tax Court's procedures and judicial review of its decisions are therefore governed by that Act. Although the doctrine of *Dobson v. Commissioner*, 320 U. S. 489, does not in any event preclude full review of the issues in this case, the judicial review provisions of the Administrative Procedure Act provide additional independent grounds for such review here. *Lincoln Electric Co. v. Commissioner*, 162 F. 2d 379 (CCA 6th). The

Tax Court's failure to observe the procedural requirements of the Act is a further reason for reversal.

ARGUMENT

I

The Correct Basis for Depreciation of the Patents Which Petitioner Acquired When it Purchased the Assets of Mitchell of California Was the Difference Between What it Paid for All the Assets and the Agreed Value of the Tangible Assets.

The basis for depreciation of the patents which petitioner acquired when it purchased the assets of Mitchell of California is its cost of those patents. Sections 114 (a), 113 (b), 113 (a), Internal Revenue Code. This much is undisputed. Determination of petitioner's cost of the patents requires, first, a determination of petitioner's cost of all the assets, and then an allocation of the proper portion of this cost to patents.

A

Petitioner's cost of all the assets was $3,100,000 because that is what it paid for them.

Harley L. Clarke bought the assets from Mitchell of California at one price and sold them to petitioner at another. The question in this case is petitioner's basis for those assets—not Harley L. Clarke's. Accordingly, petitioner's basis is to be determined by the price which petitioner paid—not by the price which Clarke paid in a prior transaction. Cost means "cost to the taxpayer." "A property may have a cost history quite different from its cost to the taxpayer." *Detroit Edison Co. v. Commissioner of Internal Revenue*, 319 U. S. 98, 102.

All of the evidence shows that petitioner's cost—the price which it paid for the assets, was $3,100,000; there is no evidence whatever to the contrary. The Tax Court's findings of fact recite: (1) that on July 12, 1929, "a proposal signed by H. L. Clarke was made to petitioner to transfer to it all the properties, business, and assets of Mitchell of California for a stated consideration of $3,100,000 in cash" (R. 40) (see also Stip. ¶3, R. 22); that on July 16, 1929, at a meeting of petitioner's board of directors, "a resolution was adopted accepting Clarke's July 12, 1929 proposal to sell the assets of Mitchell of California to petitioner for $3,100,000 and authorizing its proper officers to execute all necessary documents to carry this resolution into effect" (R. 41) (see also Stip. ¶4, R. 22); (3) that on July 27 and 29, 1929, all of the assets of Mitchell of California were transferred to petitioner (R. 42, 44) (see also Stip. ¶5, R. 22); (4) that on August 2, 1929, petitioner's account at the Chase National Bank "shows a withdrawal of $3,000,000, representing a check issued to Clarke," and that, on the same date, "H. L. Clarke's Account at Chase National Bank shows a deposit of petitioner's check for $3,000,000" (R. 47). The revenue agent's computation, reproduced in the Tax Court's opinion (R. 51), shows "cost of assets—Mitchell Camera Co. of California * * *" at $3,100,000.00. Counsel for respondent in his opening statement in the Tax Court, stated that the assets "were acquired by Mr. Clarke * * * for $1,475,000" and later "transferred to the new corporation [petitioner] at a stepped-up basis of $3,100,000.00" (R. 90). Mr. Clarke, whom the Government subpoenaed as a witness, testified that petitioner "paid $3,100,000 out of its funds to acquire the assets from me under my offer of July 12, 1929" (R. 123), and that he received that consideration (R. 106, 124).

While apparently recognizing all this, the Tax Court held that petitioner's basis must nevertheless be deter-

mined by reference to the price which Clarke paid rather than the price which petitioner paid. The Tax Court's position seems to be that, because Clarke was an officer of petitioner, had helped to organize it, and, with Fox, owned other interests which controlled petitioner, any profit which Clarke made on a deal with petitioner must be excluded in determining petitioner's cost (R. 63, 64).

Of course Clarke made a large profit on this deal. These transactions took place in the year 1929 at the height of the speculative "boom" period. Clarke was a promoter, and large promotional profits in deals of this kind were commonplace. Petitioner's charter specifically provided that a director of the corporation should not be disqualified from dealing with the corporation "as a vendor, purchaser or otherwise," that such transactions should not be void or voidable in the absence of fraud, and that no director should "be liable to account to this Corporation for any profit realized by him from or through any such transaction" when ratified by the other directors (R. 38, 39). Clarke made a profit out of the transaction such as the charter contemplated, and was taxable on it. He made similar profits on his purchase and sale of the four lamp companies (R. 122, 125). These facts serve to strengthen, rather than to weaken, petitioner's contention that it actually paid $3,100,000 for the assets—that is, Clarke's cost plus Clarke's profit. Clarke testified on cross-examination that after he contracted to buy these properties he could have transferred them to anyone (R. 125). Had he sold them to a company in which he had no interest, that purchaser's cost would of course have included Clarke's cost plus Clarke's profit. There is no more justification for excluding Clarke's profit from petitioner's cost, as respondent seeks to do, simply because Clarke's promotional activities may have put him in a better position to make this sale and realize this profit.

Clarke's transactions with, and interests in, other corporations are not relevant to, and do not alter the fact that he sold the assets in question to petitioner for \$3,100,000 and that petitioner paid him that price for the assets. Petitioner submits that this fact, which cannot be disputed on the evidence, conclusively determines petitioner's cost, and therefore basis.

In *Commissioner of Internal Revenue v. Matheson,* 82 F. 2d 380 (CCA 5), the taxpayer, who was co-executor and one of the legatees of his father's estate, agreed to accept certain stock of the estate at a price of \$130,700 as a credit against his legacy. On the date of the agreement, the market value of the stock was only \$111,200. Later, when taxpayer sold the stock, he claimed that his cost basis for measuring loss was \$130,700. The Commissioner argued that taxpayer would not have bought the stock at a price well above market value from any one else, that there must have been some personal motive or other consideration in his paying the difference, and that the correct basis was \$111,200. The Court, however, sustained the taxpayer, and held that the Board was not at liberty, without evidence, to suppose a different consideration for the stock from that which taxpayer paid.

The present case is much stronger from petitioner's point of view. Unlike the taxpayer in the *Matheson* case, appellant could not have gone into the market and purchased the assets for a lesser sum. In these circumstances, the Tax Court could not properly determine that petitioner's cost was something different from the price it concededly paid.

Nothing in *Dobson v. Commissioner,* 320 U. S. 489, precludes a full review of this question by this Court. The Supreme Court in the *Dobson* case left unchanged the principle that the Tax Court is still subject to review and reversal on questions of law, or on conclusions which

lack substantial support in the evidence. Whether petitioner's basis for assets which it purchased should be measured by the price which it paid, or the price which Clarke paid, is a clear cut question of law, for it involves a determination of what the statute means when it fixes "cost" as the basis for depreciation. Moreover, in this case, the evidence is clear and uncontroverted that petitioner paid $3,100,000 for the assets. The Tax Court's contrary conclusion has no support whatever in the record, and is inconsistent with its own findings of fact (*supra*, p. 15). Cf. *Lawton v. Commissioner,* decided November 24, 1947 (CCA 6th).

B

Petitioner's cost of the patents was $2,860,178.95—the difference between its cost of all the assets and the agreed value of the tangibles.

We have shown that petitioner's cost for all the Mitchell of California assets was $3,100,000. The stipulated value of the tangible assets acquired in that transaction is $239,821.05 (Stip ¶7, R. 23). The difference, or $2,860,178.95, is what petitioner paid for the patents, and therefore the basis on which patent depreciation should be computed.

The respondent contends, however, and the Tax Court held, that the assets included very substantial good will value, to which a large part of petitioner's purchase price must be attributed (R. 94, 63).

This argument is apparently presented as an alternative to the argument that petitioner's cost of the assets was not $3,100,000. In other words, respondent would apparently disallow, as part of petitioner's cost of the assets, the portion thereof representing Clarke's profit; or, if that cannot be done would allocate that portion of the cost to "good will" (R. 94). In reality, these arguments are not alternatives, but are different ways

of saying the same thing—that is, that the price which Clarke paid for the assets, rather than the price which petitioner paid, controls. For if, as seems clear from the respondent's own computation (R. 51), the assets did not include good will values in the hands of Clarke after he purchased them from Mitchell of California, they did not suddenly take on such values in the six weeks before he sold them to petitioner. The difference in the two prices was attributable not to good will, but to Clarke's profit. And, as we have shown under subhead "A," there is no basis for excluding this profit from petitioner's cost. The question of such exclusion being one of law in determining what constitutes "cost" under the statute, the *Dobson* rule, as we have pointed out above (p. 18), is inapplicable here.

In any event, there was no evidence from which the Tax Court could find that any part of the price which petitioner paid for the Mitchell of California assets was for good will. All the evidence is to the contrary. George A. Mitchell, who had been the engineer in charge of production and development of Mitchell of California, testified that the business of that corporation in 1929 was based upon its patents; that it was the only company having a quiet camera which could be used with sound pictures, so that it had a monopoly on cameras for use with sound; that the company's position in 1929 was due to its patents, and that good will was not a factor in the business in 1929 (R. 99, 100). Mr. Clarke, testifying as a government witness, stated that the business of Mitchell Camera of California was the manufacture of motion picture cameras under patents; that his purpose in purchasing Mitchell of California was to obtain that corporation's patents and the right to build 70 millimeter cameras (R. 123). Mr. Fox testified that Mitchell Camera of California had previously built a wide film camera for him partly under its patents, and that the purpose of

buying the company was to obtain these patents; that Mitchell of California's value to Grandeur was the value of its patents; that his interest in the company was based entirely upon the patents which it owned—not upon its good will, machinery, or buildings (R. 131). The record shows that none of this testimony was disputed or contradicted in the slightest degree. The Tax Court's findings of fact are in accord with it, for it found that "all of [Mitchell of California's] business was in patented products manufactured under patents owned by it," and "because of the patented features of the Mitchell camera, it was practically impossible to use any other camera in the production of 'sound motion pictures' * * *." (R. 28). In these circumstances, the Tax Court was not at liberty to disregard the testimony of these witnesses. *Belridge Oil Co. v. Commissioner,* 85 Fed. 2d 762 (CCA 9); *C. H. Mead Oil Co. v. Commissioner,* 72 F. 2d 22, 25 (CCA 4th); *Lawton v. Commissioner,* CCA 6th, decided November 24, 1947; *Foran v. Commissioner,* CCA 5th, decided January 20, 1948.

The monopoly in the sound film field which Mitchell of California enjoyed solely because of its patents amply substantiates the testimony of the witnesses that the value of the company was in those patents—not in good will, or something else. In *Council Tool Co. v. Commissioner,* 8 B. T. A. 1046, it was held that where petitioner had eliminated competition by purchase of competitors assets, its success thereafter was attributable, not to good will of the former competitor, but to absence of competition. This result was reached although the resolution authorizing the purchase recited good will along with other assets, and although the purchasing corporation carried good will on its books for a number of years after the purchase.

The Tax Court's finding that there was substantial value in good will in the face of this strong, uncontro-

verted evidence is based upon book entries, and the fact that Mitchell of California was a successful corporation, recognized as producing "the best motion picture cameras available" and had back orders (R. 63). But errors of fact cannot be perpetuated because they are a part of an adjustment of tax liability for a prior year, or because they result from erroneous book entries. *Doyle v. Mitchell Bros.*, 247 U. S. 179, 187, *Isbell Porter Co. v. Commissioners,* 40 F. 2d 432 (CCA 2d). This Court has pointed out that:

> "As is well known, book values assigned to corporate assets are often arbitrary, and their general unreliability is everywhere recognized." *Spreckels-Rosekrans Investment Co. v. Lewis*, 146 F. 2d 982 (CCA 9).

Mitchell of California's success and recognition in the motion picture camera field, to which the Tax Court refers, instead of showing that the company had or sold good will as a separate asset, emphasizes the value of the company's camera patents. The Tax Court expressly found that the company's monopoly position and back orders came about "because of the patented features of the Mitchell camera" (R. 28). Any other monopoly owner of these patents would have had similar success, recognition, and orders. Without these patents, Mitchell of California would have had none of these things, nor could it have obtained or filled its orders. In this situation, good will could have no separate existence, for such value as the business had lay in the value of the patents.

Moreover, the evidence is undisputed that Clarke and Fox gave no thought to good will in making this purchase. They were interested only in patents, and it was for patents alone that the consideration was paid (R. 123, 131).

The authorities are agreed that where a mixed aggregate of tangible and intangible assets are acquired for one consideration, and the business is one dependent for earnings upon patents, the cost to the purchaser of the patents is the price paid over and above the tangibles.

In *Republic Steel Corp. v. U. S.*, 40 F. Supp. 1017 (Court of Claims), plaintiff's subsidiary had purchased all of the property and assets of a company called Steel & Tubes No. 1 at a price of \$19,556,992.43. It was undisputed that the tangible assets were worth \$7,094,332.04. The question concerned the cost, as basis for depreciation, of the patents included in the assets. The plaintiff claimed that the balance of the purchase price above the tangibles was paid for the patents, while the defendant claimed that part of this price was for good will. The Court of Claims sustained the plaintiff's position. In this connection, the Court said: (40 F. Supp. at 1023):

> "* * * Apparently Steel and Tubes No. 1 did not consider that it had any good will separate and apart from its patents; in other words, if it disposed of its patents, it would not have any good will. Its president so testified, and it gave no value to it on its books. The plaintiff says it placed no value on it in determining whether or not to pay the price demanded.
>
> "But the defendant says the parties overvalued the patents, that they were not worth the sum at which the parties valued them, and it argues at length in support of this proposition. This may or may not be true; they may not have been worth what the parties thought they were. But the fact remains that they were purchased on the parties' valuation of them, and not on their actual value. The amount of \$19,556,992.43 was paid for all the assets, the tangible assets were worth \$7,091,332.04, leaving \$12,462,660.39 as the price paid for the intangible assets. The only intangible assets regarded by the parties as of any value were the patents, so it must follow that this sum was paid for the pat-

ents. It may be that the seller's good will really did have a value, but if the parties did not think so and, in computing the price to be paid, gave it no value, it must be eliminated from consideration in computing the amount paid for the other assets."

Petitioner's case is on all fours with the *Republic Steel* case. As in that case, the parties here did not consider that Mitchell of California "had any good will separate and apart from its patents" and gave no consideration to good will in making the purchase (R. 123, 131). The crux of that case, equally applicable to this one, is embodied in the Court's statement that—

> "The only intangible assets regarded by the parties as of any value were the patents, so, it must follow that this sum [balance over tangibles] was paid for the patents."

In *Illinois Pipe Line Company v. Commissioner,* 37 BTA 1070, 1079, taxpayer purchased assets of the Ohio Oil Co. consisting of pipe line properties for $20,000,000 worth of stock. Taxpayer claimed that the cost of the depreciable assets was $18,799,415, while the Commissioner claimed that their cost was only $10,191,412.14, attributing the difference to "going concern" value. The Board sustained the taxpayer. It held that the parties never intended to purchase intangibles; that—

> "The evidence * * * shows that no part of the purchase price was paid for intangibles and, further, that any 'going concern value' attached to the line exhausted with the line itself."

The evidence in the present case, with respect to the patents, is the same: the parties did not intend to buy good will; anything resembling good will was not a separate asset but inhered in the patents, and became exhausted along with the patents.

In two later cases, the Tax Court followed the *Republic Steel* case, *supra,* holding that the total price which the taxpayer had paid for an aggregate of assets was attrib-

utable to patents or other depreciables, and that no part thereof was attributable to good will, where witnesses had testified that good will was not considered a separate asset, that all the value was thought to be attributable to the other assets and that there was no intention to buy or sell good will as such.

> *American Fork & Hoe Co. v. Commissioner,* T. C. Memo Op., Sept. 22, 1943, Docket Nos. 108334, 108503, 2 TCM 842, 846, 847;
>
> *Addressograph-Multigraph Corp. et al. v. Commissioner,* T. C. Memo Op., Feb. 5, 1945, Docket Nos. 109181-108187, 111395, 4 TCM 147, 155.

On the evidence, a similar conclusion is required in the present case.

C

The Tax Court erred in sustaining a deduction of $294,-842.41 from total cost in arriving at the cost of patents, when a value of $239,821.05 was stipulated.

The respondent deducted, in arriving at petitioner's cost of the patents, $294,842.41 for "net assets other than good will" (R. 51, 65), whereas a value of $239,821.05 for the tangible assets was stipulated (Stip #7, R. 23). The difference is $55,021.36, and, as the facts show, resulted from a mathematical error—not from a deliberate allocation of values.

The Tax Court sustained respondent's action on the ground that the agreement of the former owners of the business not to compete, and the "large backlog of contracts," might be worth this difference (R. 66).

This falls on analysis. Mr. Mitchell testified that the "agreement not to compete" was merely a routine "customary agreement" (R. 102). It was particularly unimportant in this case since both of the former owners,

Boeger and Mitchell, agreed to and did continue with the new company after they sold out (R. 34, 99) and Mitchell testified that he was employed by the new company for five years—the full length of the agreement not to compete (R. 56, 102). There was no testimony by the respondent that such agreement had a value. Similarly, the Tax Court relied in part on the "large backlog of unfilled orders" to justify its sustaining the good will item (R. 63); yet, it relied on this same item (this time called "large backlog of contracts") to justify the figure placed on "net assets other than good will" (R. 66). This is sheer duplication; it is a case of blowing hot and cold at the same time.

The plain fact is that there were no such "assets other than good will." The origin of this $55,021.36 item is clearly traceable to an error in the revenue agent's 1934 computation (R. 51).

The net tangible assets reflected on petitioner's 1929 balance sheet (R. 49) add up to $239,821.05.

Land		$35,535.40
Buildings		73,938.48
Machinery & Equipment	$91,009.70	
Less: Depreciation Reserve	12,760.82	78,247.88
Land held for sale		2,050.32
Accounts Receivable		2,815.00
Inventory		50,896.77
Total		$243,483.85
Less:		
Accounts Payable	2,815.00	
Accrued payroll	847.80	
		3,662.80
Net tangible assets		$239,821.05

Patents were carried on this balance sheet at $55,021.36 (R. 49). In the 1934 computation, the agent valued patents as follows (R. 51):

Actual value paid by Harley Clarke for total assets	$1,475,000.00
Less: Net assets other than good will	294,842.41
Considered as value of patents	$1,180,157.59

Breaking down the $294,842.41 item to show its components, the computation becomes:

Actual value paid by Harley Clarke for total assets		$1,475,000.00
Less net assets other than good will		
Tangibles	$239,821.05	
Book value of patents	55,021.36	
		294,842.41
Considered as value of patents		$1,180,157.59

The agent in his 1934 computation simply erroneously added the book value of the patents to the tangibles in arriving at what he considered the actual value of the patents. Since his purpose was to compute the actual value of the patents, he should, of course, have eliminated their book value as follows:

Actual value paid by H. L. Clarke for total assets	$1,475,000.00
Less net value of tangible assets	239,821.05
Considered as value of patents	$1,235,178.95

Clearly, therefore, the $55,021.36 item, which the Tax Court says may have been due to the agreement not to compete and to the backlog of orders, is in fact simply the value at which patents were originally carried on the books, which erroneously found its way into the agent's computation.

It is taxing coincidence beyond the bounds of credibility to suggest that the identical figure, to the penny, is both the 1929 book value of the patents and the value of the intangibles on which the Tax Court relies. Therefore,

whether petitioner's basis is to be measured by the price which it paid for the patents, or, as respondent contends, by the price which Clarke paid, it is clear that, at the very least, the basis must be adjusted to include this $55,021.36 item.

The *Dobson* rule of course has no application to the Tax Court's conclusion on this point, both because the evidence does not support such a conclusion and because, as we have shown, it has its origin in pure mathematical error.

II

If Petitioner's Basis Is to Be Measured by Clarke's Cost Respondent's Computation Must Be Adjusted to Show Clarke's True Cost.

The theory of the respondent, and of the Tax Court, was that petitioner's basis must be measured by the price which Clarke, rather than petitioner, paid for the assets. Petitioner, in the first section of this brief, has shown why it believes this position to be untenable. However, if, contrary to petitioner's contention, this Court should accept respondent's theory on this branch of the case, then, at the very least, Clarke's cost, as computed by respondent, must be corrected in two respects: (1) to eliminate the mathematical error of $55,021.36 which the agent made in computing the "value of patents"; and (2) to reflect the commissions which Clarke paid in order to acquire the assets.

The first adjustment, the $55,021.36 item, has been discussed at length immediately hereinbefore, in section I-C. The commissions item will accordingly be discussed here.

Harley L. Clarke testified, as a government witness, that he paid some "very good sized commissions" to acquire the assets of Mitchell of California. He placed these commissions at between $350,000 and $400,000 (R. 117,

118, 122). This, of course, was in addition to the $1,475,000 which he paid to the owners of Mitchell of California for the assets themselves (R. 122). His testimony on this point was not questioned or disputed in any way.

The Tax Court, however, has used as Clarke's cost of the assets only the $1,475,000 figure and has failed to take into account this large commission item (R. 64, 65).

Commissions paid in acquiring property must of course be added to the price paid in determining the cost basis. *Helvering v. Winmill*, 305 U. S. 79, *Tonningsen v. Commissioner of Internal Revenue*, 61 F. 2d 199 (CCA 9th); *Young v. Commissioner of Internal Revenue*, 59 F. 2d 691 (CCA 9th).

The Tax Court has sought to justify the omission of the commissions from Clarke's cost on the ground that "to whom they were paid or for what service rendered, we are not advised" (R. 64), and has apparently confused these commissions with a different commission item of $100,000 appearing in a Senate Committee exhibit (Ex. G), (R. 65). But Clarke, as a government witness, testified that the $350,000 to $400,000 commissions were "outside of what appears on the exhibit" (R. 118). And he stated specifically that he paid these commissions "on the Mitchell Camera Corporation acquisition" (R. 122, 117, 118). It makes no difference, for present purposes, to whom the commissions were paid; the important fact is that they were paid for acquiring Mitchell assets. But if elaboration were desired, the respondent, whose witness Clarke was, should have questioned him further, for this was testimony affecting respondent's defense of his prior action. The burden shifted to him to overcome the testimony of his own witness if he could. The Tax Court does not intimate that it discredits Clarke's testimony that he paid these commissions, even if it were at liberty to do so. It makes no finding either way. It says, merely, that "more evidence than this is required

upon which to base a finding of additional cost by reason of commissions paid." (R. 65). But the evidence is clear, unequivocal, and undisputed that Clarke paid $350,000 to $400,000 in commissions in order to acquire the Mitchell of California assets. No more than this is either necessary or relevant to support petitioner's position. The commissions must therefore be included in computing Clarke's cost of the assets, and it was clear error to exclude them. Cf. *Cohan v. Commissioner,* 39 F. 2d 540 (CCA 2d); *Isbell Porter Co. v. Commissioner,* 40 F. 2d 432 (CCA 2d).

The *Dobson* rule does not preclude reversal where the Tax Court has simply disregarded, though it has not discredited, unequivocal and unrefuted testimony adverse to the party who called the witness. Moreover, the Tax Court did not find that the claimed commissions were not paid. It based its decision on what it regarded as insufficient evidence (R. 65). Whether the evidence was sufficient to justify a finding that the commissions were paid is of course a question of law which this Court may review.

In any event, if the Tax Court deemed more evidence on this issue essential to a decision it should have afforded the parties an opportunity to supply it, or have made a fair approximation under the *Cohan* rule. Therefore if this Court, contrary to our contentions, likewise deems additional evidence important to a decision, the case should be remanded either for an allowance of an approximation or for a re-hearing to supply the data in order that justice may be done. *Doernbecher Mfg. Co. v. Commissioner,* 80 F 2d 573, 574 (CCA 9th); *Lewis et al, Trustees v. Commissioner,* 160 F 2d 839 (CCA 1st).

III

The Depreciation of the Patents Should Be Computed by Reference to the Full Life of All the Patents Rather than on a Composite Average Life Basis.

Section 23 of the Internal Revenue Code (1939) provides that—

> "In computing net income there shall be allowed as deductions:
>
> "(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *"

The respondent's regulations lay down the proper rules for computing depreciation under this provision of the law. Reg. 103, Sec. 19.23 (1)-1 states that:

> "* * * The proper allowance for such depreciation is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), whereby the aggregate of the amounts so set aside, plus the salvage value, will *at the end of the useful life of the depreciable property,* equal the cost or other basis of the property * * *." (Emphasis added.)

The provisions of respondent's "Bulletin F" (272) (revised January 1942) are substantially the same. Similarly, Reg. 103, Sec. 19.23 (1)-7, dealing specifically with patents or copyrights, says:

> "* * * The allowance should be computed by the apportionment or other basis of the patent or copyright *over the life of the patent or copyright since its grant, or since its acquisition by the taxpayer,* or in the case of a copyright, since March 1, 1913, as the case may be." (Emphasis added.)

These regulations recognize, and indeed require, depreciation of patents over their entire life, which is of course the

17 year statutory life. And, as this Court said in *Douglas County Light & Water Co. v. Commissioner*, 43 F. 2d 904, 905 (CCA 9th):

> "A Treasury regulation has the force and effect of law unless it is in conflict with an express statutory provision."

The regulations undoubtedly reflect Congress' intent, in providing for a depreciation allowance, that depreciation be spread over the entire life of the assets. The Supreme Court has pointed out that:

> "Congress has provided for deductions of annual amounts of depreciation which, along with salvage value, will replace the original investment of the property *at the time of its retirement.*" (Emphasis added). *Virginian Hotel Corp. v. Helvering*, 319 U. S. 523, 528.

This is the only sound and reasonable basis for taking depreciation, both from an accounting and economic point of view. *Detroit Edison Co. v. Commissioner of Internal Revenue*, 319 U. S. 98, 101.

Where a group of patents are acquired, having varying lives, the requirement that depreciation be spread over their full lives is met by following the formula which the Board of Tax Appeals adopted in *Simmons Company v. Commissioner*, 8 BTA 631, 644 (aff'd 33 F. 2d 75, cert. den. 280 U. S. 588). Under that formula, the allowable depreciation deduction in each year would be an amount bearing the same ratio to the total value of all the patents as the patent life expiring in that year bears to the total unexpired life on the date of acquisition. Depreciation is thus spread over the entire life of all the patents. This is the only formula which will satisfy the quoted regulations and is the one which appellant wishes to use in this case. The respondent, on the other hand, would require that petitioner's depreciation be taken over a period of the average lives of the patents from the date of acquisition—12.3666 years.

The thirty patents acquired by petitioner had life expiration dates extending from 1936 to 1950; *seventeen of these patents will expire after the last year in which respondent has allowed depreciation* (Ex. 16). Clearly, respondent's insistence that the patents be depreciated on an average life basis cannot be squared with his regulations, requiring depreciation to be spread over the entire "life of the patent."

The cases upon which the Tax Court relies to sustain the average life formula (R. 67) all involved entirely different issues from that in this case. In *Union Metals Mfg. Co.*, 4 BTA 287, and *Syracuse Food Products Corp.*, 21 BTA 865, the Board merely held that a group of patents need not be valued and depreciated individually, but might be depreciated as a group over their average lives. In *Prophylactic Brush Co.*, 25 BTA 676, the Board held that, where an original invention was patented in 1909, and improvements in 1915, depreciation would be over the average life of both, rather than over the life of the last patent as contended for by the Government. In these cases, the parties were agreed that if the patents were to be considered as an aggregate, depreciation would be on the average life basis. While the Board in these cases does tolerate or "recognize" the average life formula, as the Tax Court says (R. 67), it did not have before it, and did not decide, the issue now presented; namely, whether a taxpayer who wishes to depreciate patents over their entire useful life as the regulations require may instead be compelled to use an average life formula which exhausts his basis long before the end of the life of the patents.

This Court had an analogous situation presented in *Wells Fargo Bank & Union Trust Co. v. Commissioner*, No. 11502, decided August 27, 1947. The question there was whether the cost of cancellation of a lease for the purpose of obtaining a new lease should be amortized over

the term of the new lease, or the unexpired term of the old lease. The Tax Court, relying on earlier Board cases, has held that the cost must be amortized over the unexpired term of the old lease. This Court reversed, holding that the cost of cancellation was amortizable over the term of the new lease. With reference to the Board cases on which the Tax Court had relied in reaching a contrary conclusion, this Court said:

> "While it may be admitted that the Tax Court has gradually evolved such a rule [amortization over unexpired term of old lease], yet * * * the question of how the cost of cancellation was to be amortized was never presented. In all the cases cited in the Tax Court opinion, the taxpayer argued that the cost of cancellation should be deductible as an ordinary expense of doing business while the Commissioner claimed that the amount was amortizable. *Neither side ever raised the issue of the period of amortization.* * * *." (Emphasis added)

Similarly, in the present case, *the issue now presented,* as to the period of depreciation, *was never raised or decided in the Board cases upon which the Tax Court relies.* Those cases are therefore not persuasive here. Moreover, so far as appears, the question has never been raised in or decided by an appellate court. Petitioner submits that for reasons heretofore stated it should now be decided in accordance with its position.

The *Wells Fargo case,* supra is important here in another respect. There, as here, the taxpayer contended that amortization should be spread over one period while the Commissioner contended for another. Plausible argument could be, and was, advanced in support of both positions. Yet this Court held that the "decision of the Tax Court in this matter denying to petitioner the right to amortize the cost of cancelling the old lease over the terms of the new lease, should be and hereby is reversed." Similarly, in the present case, even if the average life formula is one

possible method of depreciating patents, yet it is unquestioned that the "full life" formula set forth in the *Simmons* case is also a proper and reasonable method, and the only method which spreads the basis over the full life of the patents. The taxpayer in this case, therefore, like the taxpayer in the *Wells Fargo* case, should not be denied the right to use an admittedly proper method of depreciation simply because the respondent desires it to use some other method.

But the Tax Court seems to imply that petitioner is estopped to depreciate on a full life basis now because for some years it used the average life formula fixed in the revenue agent's 1934 computation. It erroneously relies on *Virginia Hotel Corporation* v. *Helvering,* 319 U. S. 523 for this proposition (R 67). The Supreme Court held in that case that where the Commissioner had determined the useful life of equipment to be greater than petitioner had claimed, resulting in a lower annual rate of depreciation, the petitioner might not apply this lower rate to the prior years 1931-1936 (years not in controversy) so as to create a higher remaining basis for depreciation in the taxable year (1938). This was because depreciation at the old rate for prior years had been "allowed" under sec. 113 (b)(1)(B) of the Internal Revenue Code, by acceptance of the former returns without challenge, 319 U. S. at 527. The issue there related to *cumulative* depreciation rather than to *current* depreciation.

Whether the *Virginian Hotel* doctrine should bar petitioner from revising its basis for the prior years 1932 through 1938 to reflect the depreciation properly allowable is a question which is discussed in a subsequent section of this brief (infra p. 36). Whatever the answer to that question may be, it is certainly clear that the *Virginian Hotel* case has no application to the years 1939 through 1941 since these are the years as to which petitioner's tax liability is here in issue. These years are before the Court in

this proceeding and are still open to depreciation adjustments of any kind, for as to them no depreciation has been finally "allowed." There can therefore be no question of "estoppel," or otherwise, as to petitioner's right to take depreciation on a full life basis under the *Simmons* formula for the years 1939 through 1941.

The total life of the patents acquired by petitioner was 4452 months, with 212, 204, and 204 months being exhausted in the years 1939, 1940 and 1941, respectively (Ex. 16). Applying the *Simmons* rule to $2,860,178.95, petitioner's cost of the patents, the allowable depreciation for these years would be:

1939	$136,199.40
1940	131,059.80
1941	131,059.80

In contrast with the above, respondent has allowed depreciation as follows:

1939	$ 95,430.50
1940	95,430.50
1941	13,637.89

(These figures differ from those shown in respondent's notice of deficiency and the Tax Court's opinion (R 55) because in the Rule 50 computation the respondent acknowledged that depreciation allowed to December 31, 1938, on the original patents should be $975,658.70 instead of $1,035,539.75 as shown in the notice of deficiency (R 14) and the Tax Court's opinion (R 55). This accounts for most of the difference between the deficiency originally proposed ($73,478.94) (R 26) and the amount fixed in the Tax Court's decision ($47,720.78) (R 68).

The petitioner submits that, whatever its basis be for the patents, it is entitled to use the *Simmons*, or full life, method of depreciation.

IV

The Cumulative Depreciation on Patents to December 31, 1938, Should Be Adjusted to Reflect the Correct Amount of Depreciation for Prior Years.

In his 1934 computation, respondent determined that an annual patent depreciation of $95,430.50 was allowable on an average life formula of 12.666 years (R. 51). Petitioner has shown in prior sections of this brief that the respondent erred both in the cost basis which he fixed for the patents, and in requiring depreciation on an average life, rather than full life, formula. Therefore, the amount of depreciation by which the basis was reduced as of December 31, 1938, should now be adjusted to reflect the correct cumulative depreciation on the correct basis of the patents, whether computed by the full life or average life formula.

Such correction will not result in a windfall or undeserved advantage to petitioner, since it sustained substantial losses during the years 1932 through 1938 and therefore secured no tax benefit from the excessive depreciation charges (R 52, 53). (There might be a small tax benefit for the single year 1936, but petitioner does not contend for correction to the extent that this would result in tax benefit having been realized.) The government will not therefore be prejudiced in any way if the basis is now made to reflect the amount of depreciation properly allowable in prior years.

Nor is *Virginian Hotel Corporation* v. *Helvering,* 319 U. S. 523, a bar to correction of these past errors. The Supreme Court held in that case that a taxpayer who in prior years had taken depreciation on the basis of a short life estimate could not, upon determination of a longer life estimate, go back and revise his basis to reflect the new estimate. There is no question in the present case of revising the estimated life of assets, since patents have a fixed statu-

tory life of seventeen years. Obviously, in the present case, the petitioner's taking depreciation at an average of $107,000 (R. 52, 53) when the respondent in 1934 had fixed a rate of $95,430.50 (R. 51), with no resulting tax benefit, was due to pure error. Likewise, if, as petitioner believes, the *Simmons* formula, rather than the average life formula, should have been used, the resulting rate of depreciation is based on mathematical error. Nothing in the *Virginian Hotel* case holds or implies that errors of this sort, which resulted in no tax benefit, are beyond correction. The situation here is no different tax-wise from that where an erroneous figure is listed for depreciation through typographical error. It cannot be said that depreciation is "allowed" within the meaning of the statute (§ 113 (b) (1) (B) IRC), merely by acceptance of the return, where the figure listed for depreciation is based upon pure mistake and the correction of the figures would have made no difference in the tax.

Moreover, the case of *Rainier Brewing Company* v. *Commissioner,* 7 T. C. 162 (affirmed by this Court January 9, 1948), indicates that the *Virginian Hotel* case does not require that unallowable depreciation be deducted where intangibles are involved. In the *Rainier* case, the taxpayer's predecessor was allowed in prior years unallowable obsolesence on a trade name. The Commissioner contended that since he had allowed the obsolesence in the audit of the returns, the taxpayer could not restore the unallowable obsolesence to the basis for the property. The Tax Court disagreed, however, holding that the *Virginian Hotel* case was "not controlling" and "is distinguishable on its facts and the rationale of that decision is not applicable here." 7 T. C. at 178. The Court accordingly limited the amount by which prior obsolesence reduced the basis to the actual tax benefit resulting from the erroneous deduction.

Petitioner submits that here, as in the *Rainier* case, the patent basis may and should be corrected to reflect only

the depreciation properly allowable, except to the extent that excessive depreciation actually resulted in tax benefit.

The *Dobson* rule is clearly inapplicable to this issue, since the question here is one of pure statutory construction. As in the *Virginian Hotel* case, supra, that question is, of course, open to appellate review.

V

The Tax Court Is an Agency Within the Meaning of the Administrative Procedure Act, and Its Procedures and the Reviewability of Its Decisions Are Governed by that Act.

The Administrative Procedure Act (60 Stat. 237, 5 U. S. C. § 1001) prescribes procedures which agencies of the United States must follow in formulating decisions, and also sets forth the scope and standard of judicial review of such decisions. Both of these features of the Act are important in this case if the Tax Court is an agency subject to the Act. Petitioner earnestly submits that it is such an agency, and that both its procedures and the reviewability of its decision are therefore governed by the provisions of that Act.

A

The Tax Court is an agency within the Administrative Procedure Act.

The Administrative Procedure Act applies to all agencies of the United States. Section 2 (a) of that Act defines "agency" to mean:

> "each authority (whether or not within or subject to review by another agency) of the Government of the United States other than Congress, the courts, or the governments of the possessions, Territories, or the District of Columbia."

The Tax Court is clearly not a court in any accurate sense. The Tax Court's predecessor, the Board of Tax Appeals, was created by the Revenue Act of 1924 (43 Stat. 253, 338) as "an independent agency in the executive branch of the Government." The Internal Revenue Code (§ 1100) when enacted, described the Board in the same way.

The Supreme Court, in *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716, 725 said:

> "The Board of Tax Appeals is not a court. It is an executive or administrative board, upon the decision of which the parties are given an opportunity to base a petition for review to the courts after the administrative inquiry of the board has been had and decided."

The change of the Board's name to "Tax Court," and the designation of its members as "judges," in no way affected the status of the tribunal as an independent agency in the executive branch. The Committee Report (H. R. Rept. No. 2333, 77th Cong. 2d sess. pp. 172, 173) explaining § 504 of the Revenue Act of 1942 (56 Stat. 957) which effected the changes says:

> "This section merely changes the names by which the Board of Tax Appeals, its chairman and its members are known. No change is made in its status. The Board, which will hereafter be known as the United States Tax Court, is continued as an independent agency in the executive branch of the Government. *Thus its status as an executive or administrative board is unchanged.* Old Colony Trust Co. v. Commissioner, 279 U. S. 716, 725 (1929). * * * The Board and its divisions will continue to have the same jurisdiction, powers and duties as provided by existing law." (Emphasis added)

Both the Supreme Court and Circuit Courts of Appeal have recognized, since the Board's change of name to Tax Court, that the tribunal is still "an independent agency in the executive branch of the Government." *Commissioner*

v. *Gooch,* 320 U. S. 418, 420; *Dobson* v. *Commissioner,* 320 U. S. 489; *Hutchings-Sealy National Bank* v. *Commissioner,* 141 F 2d 422 (CCA 5th).

The Tax Court, like other agencies, is therefore clearly subject to the Administrative Procedure Act unless Congress intended to exempt from the Act not only tribunals which are courts in fact but also an administrative agency which is called a court. But neither the Act itself nor its legislative history evinces any such intent. On the contrary, they indicate that Congress intended the Act to apply to the Tax Court as fully as to other agencies of the government.

The committee reports make clear that the definition of "agency" in the Act excludes only "legislative, judicial, and territorial authorities" and includes "any other 'authority' ". Legislative History, Administrative Procedure Act, Senate Document No. 248, 79th Cong. 2d sess., pp. 196, 252 (hereinafter cited Legis. Hist.). Congress' intention to exclude "judicial authorities" from the operation of the Act does not justify exempting a body which it had previously set up as "an independent agency in the executive branch of the Government." Agencies in the executive branch are precisely what the definition is designed to include. It cannot be assumed that Congress, when it enacted the Administrative Procedure Act and made it apply to all agencies, was ignorant of its own law of a few years before setting up the Tax Court as an independent agency in the executive branch.

A Senate Judiciary Committee Print, (Legis. Hist. p. 12), explaining the derivation and meaning of the various provisions of the Administrative Procedure Act, says that the definition of "agency" in that Act is substantially the same as in the Federal Register Act. This is reasonable, since agencies must utilize the Federal Register in complying with several of the provisions of the Administrative Procedure Act. The Federal Register Act, like the Adminis-

trative Procedure Act, defines "agency" broadly to include all authority in the executive branch but to exclude specifically the legislative and judicial branches (Sec. 4, 49 Stat. 500, 44 U. S. C. 304). The Tax Court, both before and after its change in name, has regarded itself as an "agency" rather than a "court" within the Federal Register Act, for it has consistently published its rules as "agencies" under that Act are required to do. (See Title 26, Chapter III of Code of Federal Regulations, and annual supplements; also 1 CFR § 2.2(d)). Yet, in view of the inter-relation of the two Acts, and particularly of their respective definitions of "agency" it seems clear that if the Tax Court is an agency for purposes of the Federal Register Act, it is equally an agency for purposes of the Administrative Procedure Act.

Further examination into the history of the Administrative Procedure Act bears out petitioner's position that the Tax Court is an agency subject to the Act.

The Attorney General's Committee on Administrative Procedure, appointed in 1939 at the request of the President to investigate the "need for procedural reform in the field of administrative law," made exhaustive studies covering most of the agencies in the executive branch. The results of its studies were published in a "Final Report of the Attorney General's Committee on Administrative Procedure," (Sen. Doc. No. 8, 77th Cong. 1st sess. (hereinafter cited "Final Report")), and twenty-seven monographs which it prepared on individual agencies. The Board of Tax Appeals was one of the agencies which the Committee studied, and one of its monographs discusses the Board. Sen. Doc. No. 10, part 9, 77th Cong. 1st sess. pp. 69, 83. Nothing in the Final Report or the monograph indicates that the Committee regarded the Board as unique or outside its principal recommendations. The contrary would seem to be clearly true (see Final Report, p. 167).

In a "Manual" which the Department of Justice has prepared on the Administrative Procedure Act, the present Attorney General points out (p. 5) that

> "The main origins of the present Administrative Procedure Act may be found in that [Final] Report, and in the so-called majority and minority recommendations submitted by the Committee."

And again, on page 8 of the "Manual," it is stated that

> "The legislative history of the Administrative Procedure Act really begins with the Final Report of the Attorney General's Committee on Administrative Procedure."

The Congressional Committee Reports also point out that, in preparing the bill which became the Administrative Procedure Act, careful attention was paid to the earlier work of the Attorney General's Committee. (Committee Reports, Legis. Hist. pp. 190, 246.). A Senate Judiciary Committee "print" was issued showing the parallel between each provision of the new proposed law and the recommendations of the Attorney General's Committee (Legis. Hist. p. 11 et seq.).

In the absence of any clear indication to the contrary it is reasonable to assume that the coverage of agencies by the Administrative Procedure Act is at least as broad as that envisaged by the studies and recommendations of the Attorney General's Committee.

Had the name of the Board of Tax Appeals remained unchanged it would seem to be beyond serious dispute that the Administrative Procedure Act applied to it. But every reason for applying the Act to the tribunal were it still called a Board is equally present now that it is called a Tax Court, since the change in name did not make the tribunal any the less an agency or otherwise affect its functions (see supra p. 39). Congress' purpose, in enacting a uniform code of procedure and standard of judicial review for all agencies of the government, is as equally

applicable to the Tax Court as to other agencies. Had Congress intended to exempt the Tax Court, it would have been easy enough to say so specifically.

As against all this, the argument that the Tax Court is not subject to the Act is based upon a "dictum" of the Attorney General in a letter to Senator McCarran while the bill was pending. Commenting on the exemption of courts in §2 of the Act, the Attorney General said—

> "'Court' includes the Tax Court, Court of Customs and Patent Appeals, the Court of Claims and similar courts. This act does not apply to their procedure nor affect the requirement of resort thereto." Legis. Hist. p. 224.

The Attorney General does not indicate how he arrives at this conclusion with respect to the Tax Court. The Court of Customs and Patent Appeals and the Court of Claims are quite different; they are legislative courts of record provided for in the Judicial Code (28 U. S. C. 301, 241), and have been so recognized by the Supreme Court. *Ex Parte Bakelite Corp.*, 279 U. S. 438; *Williams* v. *United States*, 289 U. S. 553. It appears that the Attorney General was misled by the word "court." In any case, it is clear that he had not carefully considered the problem, and his "dictum" is entitled to no weight in construing the legislative intention in view of the strong evidence to the contrary.

The Sixth Circuit Court of Appeals in *Lincoln Electric Co.* v. *Commissioner*, 162 F 2d 379, held, in line with petitioner's contentions here, that the Tax Court is an agency subject to the Administrative Procedure Act, and that judicial review of the Tax Court's decisions would be governed by that Act rather than by the *Dobson* rule. It reiterated this view in *Dawson* v. *Commissioner*, decided September 22, 1947. Petitioner respectfully submits that this Court should take the same view.

B

The Judicial Review Provisions of the Administrative Procedure Act have broadened this Court's power to review Tax Court decisions.

Section 10 (e) of the Adminstrative Procedure Act provides that the reviewing court shall set aside agency action, findings, and conclusions "unsupported by substantial evidence," and that—

> "In making the foregoing determinations the court shall review the whole record or such portions thereof as may be cited by any party * * *."

The House Committee report (Legis. Hist. p. 279) explains these provisions as follows:

> " 'Substantial evidence' means evidence *which on the whole record is clearly substantial, plainly sufficient to support a finding or conclusion* * * * *and material to the issues.* * * * Although the agency must do so in the first instance, under this bill *it will be the duty of the courts to determine* in the final analysis and *in the exercise of their independent judgment whether on the whole of the proofs brought to their attention the evidence in a given instance is sufficiently substantial to support a finding, conclusion or other agency action or inaction."* (Emphasis supplied).

As the Sixth Circuit Court of Appeals pointed out in the *Lincoln Electric* case, supra, appellate power of review "doubtless has been broadened" by these provisions. Although we have shown in previous sections of this brief that the *Dobson* rule does not preclude full review of the issues in this case in any event, the Administrative Procedure Act is thus an additional and independent reason why petitioner is entitled to such review. For the Act has clearly restored to appellate courts the powers of review which they exercised before the limitations of the *Dobson* rule were imposed. *Lincoln Electric Co.* v. *Commissioner, supra.*

C

The Tax Court failed to observe the procedure provisions of the Administrative Procedure Act.

Petitioner on July 24, 1947, filed a motion to vacate and set aside the findings and opinion of the Tax Court on the ground that the Tax Court is an "agency" governed by the Administrative Procedure Act, and petitioner had no opportunity, as required by that Act, to submit its objections and exceptions to the Tax Court's "initial" decision before it became final (R 70). The Tax Court denied this motion.

Section 7 (a) of the Act provides that cases may be heard by: "(1) the agency, (2) one or more members of the body which comprises the agency, or (3) one or more examiners appointed as provided in this Act." Section 8 (a) provides that in cases where the agency itself has not presided at the reception of the evidence the officer who presided shall make an initial or recommended decision, from which there shall be an opportunity for appeal to, or review by, the agency. Section 8 (b) provides that a party shall have an opportunity to submit exceptions to the decision or recommended decision of the hearing officer prior to agency review. On this phase of the Act the Attorney General's interpretation seems correct; he explains this provision as follows (Legis. Hist. p. 229):

> "Section 8(b) Prior to each recommended, initial, or tentative decision parties shall have a timely opportunity to submit proposed findings and conclusions, and prior to each decision upon agency review of either the decision of subordinate officers or of the agency's tentative decision, to submit exceptions to the initial, recommended, or tentative decision, as the case may be. * * * "

Since the Tax Court judge who heard this case is a member "of the body which comprises the agency," rather than the agency itself, petitioner was entitled, under the above provisions of the Act, to file exceptions to his report,

and to opportunity for review by, or on behalf of, the Tax Court itself. Because the Tax Court takes the position, erroneously petitioner submits, that it is a court rather than an agency, petitioner was accorded neither of these rights. This denial is clearly reversible error under section 10 (e) (B) of the Act which directs reviewing courts to

> "hold unlawful and set aside agency action, findings, and conclusions found to be * * * (4) without observance of procedure required by law * * * ."

If it is thought that for some reason the Tax Court should be exempted from the requirements of the Administrative Procedure Act, this of course is a job for Congress rather than the courts. A bill which would accomplish this result by making the Tax Court a court in fact as well as in name is now pending before the Congress. H. R. 3214, 80th Cong. 1st sess. The fact that the legislators regard such a bill as necessary to remove the Tax Court from the operation of the Administrative Procedure Act (See Cong. Rec. July 7, 1947, pp. 8850 et seq) strengthens petitioner's contention that the Tax Court is presently subject to that Act, and that its failure to follow the Act's provisions requires reversal by this Court.

CONCLUSION

Wherefore it is submitted that the decision of the Tax Court should be reversed.

Respectfully submitted,

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